
3000 UNITY

Revenue and Taxation Code §25101 provides that when the income of a taxpayer is attributable to sources both within and without California, the taxpayer is required to measure its franchise tax liability by its income attributable to sources within the state. The portion of the total income that is considered to be attributable to California is determined in accordance with unitary business principles.

Under the unitary method, all of the activities comprising a single trade or business are viewed as a single unit, irrespective of whether those activities are conducted by divisions of a single corporation or by commonly owned or controlled corporations. The business income from all of the unitary business activities is combined into a single report (the combined report). An apportionment formula is then applied to the combined business income to determine the portion attributable to California.

Although R&TC §25101 provides the general authority for use of the unitary method, the application of this concept has not been defined by statute. Instead, the law has evolved through a series of judicial decisions.

This section of the manual will discuss the development and application of the unitary concept and some of the key court and SBE decisions that have helped to shape the current interpretation of a unitary business. The following sections (beginning with MATM 3500) will focus on specific audit steps and techniques for performing a unitary audit.

Reviewed: December 2002

3005 DEVELOPMENT OF THE UNITARY CONCEPT

The theory underlying the unitary business principle has its roots in real property tax law, where it arose in the context of railroad taxation. In *Union Pacific Railway Co. v. Ryan* ((1884) 113 U.S. 516), the United States Supreme Court recognized that the value of a railroad could not be measured merely by looking to the value of the property located within a specific geographic area. The Court found that the value of a railroad depends upon the whole line as a unit, to be used as a thoroughfare and means of transportation. A separate mile or two of its length is almost valueless. The Court approved a method enacted by the city of Cheyenne that taxed the value of the track within its city limits as a percentage of the value of the entire railroad line. In 1897, this concept of "unit" taxation was expanded to apply to a non-rail business that was operated in several states (*Adams Express Co. v. Ohio* (1897) 165 U.S. 194).

The next landmark in the development of unitary theory was the 1920 Supreme Court decision in *Underwood Typewriter Co. v. Chamberlain*, (1920) 254 U.S. 113, 65 L.Ed. 165, 17 S.Ct. 305. This was the first case in which the use of an apportionment formula for income tax purposes was approved. In approving the formula used by Connecticut to determine the amount of income from a multistate business that was attributable to that state, the court commented that the profits of the corporation were largely earned by a series of transactions beginning with manufacture in Connecticut and ending with sale in other states. At no time, however, did the Court refer to the operation as being "unitary."

The first express classification of a unitary business for state income tax purposes was made by the court in the case of *Bass, Ratcliff & Gretton, Ltd v. State Tax Commission* (1924), 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82. In that case, the Court stated:

"So in the present case we are of the opinion that, as the Company carried on the unitary business of manufacturing and selling ale, in which its profits were earned by a series of transactions beginning with the manufacture in England and ending in sales in New York and other places - the process of manufacturing resulting in no profits until it ends in sales - the state was justified in attributing to New York a just proportion of the profits earned by the Company from such unitary business." (emphasis added.)

Edison California Stores v. McColgan ((1947) 30 Cal.2d 472) was the first case to extend the unitary concept to multiple entities. In that case, the business activity was carried on by a group of corporations rather than by divisions of a single corporation. The Court validated the use of the unitary business concept to allow apportionment of the combined income of a multi-corporate group. (The constitutionality of applying this concept to multiple corporations was later confirmed in *Container Corporation v. Franchise Tax Board* (1983) 463 U.S. 159, aff'g 117 Cal. App.3d 988 (1981).)

In *Superior Oil Co. v. Franchise Tax Board* (1963), 60 Cal.2d 406, 386 Pac.2d 33, the FTB had argued that the unitary concept was only applicable if the in-state activities could not reasonably be computed separately from the out-of-state activities. The California Supreme Court disagreed, holding that if a unitary business derives its income from sources within and outside the state, then formula apportionment is mandatory under the language of former §24301 (now R&TC §25101). (Also *Honolulu Oil Corp. v. Franchise Tax Board* (1963) 60 Cal.2d 417.)

Reviewed: December 2002

3010 Direct Integration Between Each Subsidiary Unnecessary

In Appeal of Monsanto Company, Cal. St. Bd. of Equal., November 6, 1970, the SBE held that it is not necessary for the taxpayer's activities in California to be directly integrated with the activities of each other subsidiary everywhere in order for the subsidiaries' activities to be included in the California combined report. In that case, the taxpayer argued that its subsidiary, Chemstrand Corporation, was not a part of the unitary business because it did not contribute to or depend upon the California operation. Although Chemstrand had significant dealings with the taxpayer's operations outside the state, it had no direct dealings with the California facility, and none of the products sold by the taxpayer to Chemstrand had any connection with the taxpayer's California locations. The SBE rejected this argument and concluded:

"This argument misconceives the unitary business concept. All that need be shown is that during the critical period Chemstrand formed an inseparable part of appellant's unitary business wherever conducted. By attempting to establish a dichotomy between appellant's California operations and Chemstrand, appellant would have us ignore other parts of appellant's business which cannot justifiably be separate from either Chemstrand or the California operations."

Although the subsidiary in the Monsanto appeal had no direct connections with its parent's California operations, it did have connections with its parent's out-of-state divisions. This concept was applied to separate corporations in *Appeal of Aimor Corporation*, Cal. St. Bd. of Equal., October 26, 1983. In *Aimor*, both a U.S. subsidiary and a Japanese subsidiary had ties with the Japanese parent, but neither subsidiary had any connection with one another. Citing *Monsanto*, the SBE held that all three corporations were engaged in a single unitary trade or business.

Reviewed: December 2002

3015 Business Operating Entirely Within California

By its terms, R&TC §25101 applies only to taxpayers with income derived from or attributable to sources both within and outside the state. That section therefore does not extend the authority for combined reporting to corporations operating entirely within California. For taxable years beginning on or after January 1, 1980 however, R&TC §25101.15 was enacted to allow wholly in-state corporations to elect to determine their income in accordance with R&TC §25101. Currently, the department allows taxpayers to elect on a year-by-year basis.

When two or more corporations conduct a unitary business wholly within California, the taxpayers have the option whether to file a combined report or use separate accounting. In order to be eligible to file a combined report however, the corporations *must be unitary* under the same standards as are applied to multi-jurisdictional businesses.

Reviewed: December 2002

3020 Application Of The Unitary Method To International Businesses

Unitary business principles are applied whether the unitary business is carried on over state lines or over international boundaries. The United States Supreme Court first sanctioned application of the unitary method to the worldwide activities of a single corporation in *Bass, Ratcliff & Gretton, Ltd v. State Tax Commission* (1924), 266 U.S. 271, 69 L.Ed. 282, 45 S.Ct. 82. Since then, the Court has upheld the constitutionality of worldwide application of the unitary method to both domestic-owned and foreign-owned groups of corporations (*Barclays Bank Plc v. Franchise Tax Board, Colgate-Palmolive Co. v. Franchise Tax Board*, 114 S.Ct. 2268 (1994), aff'g 10 Cal. App. 4th 1742 (3d Dist., 1992) and 10 Cal.App.4th 1768 (3d Dist., 1992)).

In the *Barclays Bank and Colgate-Palmolive* decision the U.S. Supreme Court addressed both Commerce Clause and Due Process arguments concerning the constitutionality of worldwide combined reporting. This decision consolidated the *Barclays Bank* case (a foreign parent of a multinational group) and the *Colgate-Palmolive* case (a domestic parent with subsidiaries operating worldwide). In reaching its decision, the Court cited *Complete Auto Transit, Inc. v. Brady* (430 U.S. 274, 279 (1977)) in holding that, absent congressional approval, a state tax on interstate commerce would violate the Commerce Clause if it:

1. applies to an activity lacking a substantial nexus to the taxing state;
2. is not fairly apportioned;
3. discriminates against interstate commerce; or
4. is not fairly related to the services the state provides;

The Court went on to hold that a tax affecting foreign commerce would be subject to two additional criteria. Such a tax would not survive Commerce Clause scrutiny if it:

5. enhances the risk of multiple taxation; or
6. prevents the federal government from speaking with one voice in international trade

The Court found that Barclays and Colgate met the nexus requirement, had not demonstrated the lack of a "rational relationship between the income attributed to the State and the intrastate values of the enterprise" and had not shown that the income attributed to California was "out of all appropriate proportion to the business transacted by the [taxpayers] in that State." The taxpayer's claim of

unconstitutional discrimination was rejected because it had not been demonstrated that California's tax system imposed inordinate compliance burdens on foreign enterprises. (California's "reasonable approximations" method of reducing the compliance burden for foreign multinationals was also held to satisfy the Due Process requirement.) The Court then held that California's use of the worldwide unitary method did not inevitably result in multiple taxation, and observed that some risk of multiple taxation may occur in whatever taxing scheme the State adopts. The fact that Congress did not prohibit worldwide combined reporting reinforced the Court's conclusion that Congress "had implicitly permitted" that method. The implication to be drawn was that Congress did not believe that worldwide combined reporting prevented the federal government from speaking with one voice. The ultimate holding was that "the Constitution does not impede application of California's corporate franchise tax to Barclays and Colgate."

Reviewed: December 2002

3030 DEVELOPMENT OF TESTS FOR DETERMINING UNITY

A unitary business was first defined by the courts in the case of *Butler Bros. v. McColgan* (1941), 17Cal.2d 664; *affd*, 315 U.S. 501, 86 L.Ed. 991, 62 S.Ct. 701. In that case, the California Supreme Court established the "three unities" test for determining the presence of a unitary business. Butler Bros. was engaged in a wholesale dry goods and general merchandising business that operated in various states. Although each of the distributing outlets kept its own books of account, made its own sales, and otherwise handled many of its own functions, a central buying division ordered the goods for the outlets and thus received favorable prices because of volume purchases. Indirect expenses of the business such as executive salaries, corporate overhead, and the costs of operating the central buying division and a central advertising division were allocated to each outlet by recognized accounting principles, the accuracy of which was stipulated by both parties. By using separate accounting, the California operations would have resulted in a loss, but overall the corporation made a profit. The sole question before the court was whether a three-factor formula of property, payroll, and sales should be used to apportion a part of the overall profit to California, or whether separate accounting should be allowed. The courts, including the United States Supreme Court, which affirmed the California court decision, held that the use of a formula was proper. The California Supreme Court stated:

" . . . it is our opinion that the unitary nature of appellant's business is definitely established by the presence of the following circumstances: (1) Unity of ownership; (2) Unity of operation as evidenced by central purchasing, advertising, accounting and management divisions; and (3) Unity of use in its centralized executive force and general system of operations."

The Court was again required to determine whether or not a business was unitary in the case of *Edison California Stores v. McColgan* ((1947) 30 Cal.2d 472). In analyzing the presence of unity in that case, the Court formulated the "contribution or dependency test" under which a business will be unitary if the operations in California contribute to or are dependent upon the operation of the business outside the state. Specifically, the Court stated:

"If the operation of the portion of the business done within the state is dependent upon or contributes to the operation of the business without the state, the operations are unitary; otherwise, if there is no such dependency, the business within the state may be considered to be separate."

The California courts have consistently applied the three unities test and the contribution or dependency test over the years. In the early eighties however, the United States Supreme Court also began to refer to a unitary business as one that exhibits "contributions to income resulting from functional integration, centralization of management and economies of scale." (*F.W. Woolworth Co. v. Taxation and Revenue Dept. of the State of N.M.*, (1982) 458 U.S. 354, 366, 73 L.Ed.2d 819, 102 S.Ct. 3128; *Mobil Oil Corp. v. Vermont* (1980) 445 U.S. 425, 63 L.Ed.2d 510, 100 S.Ct. 1223.) Such

contributions are evidenced by a flow of *value* (not necessarily a flow of goods) between the components of the business operations (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App.3d 988 (1981)). These judicial interpretations are often viewed as variations of the contribution or dependency test.

In [FTB Notice 1992-4](#), the department stated its policy that each of the above judicially acceptable tests apply with equal force, and that a finding of unity will result when any one of the tests has been met. The Notice also pointed out that the test in CCR §25120(b), which requires a determination of unity "if there is evidence to indicate that the segments under consideration are integrated with, dependent upon or contribute to each other and the operations of the taxpayer as a whole," has been interpreted as consistent with the judicially established tests. In *A.M. Castle & Co. v. FTB*, 36 Cal.App4th 1794 (1995), the California Court of Appeal confirmed that the three unities and contribution or dependency tests are alternative tests, and that as long as one of the tests has been met, unity will not be denied just because the other test is not also met.

Reviewed: December 2002

3035 Application Of The Unitary Tests

Although the focus of the analysis may differ slightly between the unitary tests, the factual development that will be necessary in order to make a unitary determination will be essentially the same for each test. Unity of ownership is always required, and this aspect of the unitary analysis will be discussed in MATM 3050. Once ownership has been established, the level of integration existing with respect to the functions and activities of the business will need to be established. The unitary test that best fits the unique facts of each case should then be applied in order to determine whether the activities are unitary.

Reviewed: December 2002

3040 Three Unities Test

The three elements of unity set forth in the Butler Brothers decision are unity of ownership (MATM 3050); unity of operations as evidenced by central purchasing, advertising, accounting and management divisions; and unity of use in a centralized executive force and general system of operations. The test is satisfied if all three of the unities are found to be present.

The Court in *Chase Brass & Copper Co., Inc. v Franchise Tax Board* (1970) 10 Cal.App.3d 496 observed that:

"Although there is not a clear demarcation between what is 'operation' and what is 'use,' in general it may be said that the acts falling within the category of 'operation' are the staff functions, and those within 'use' are the line functions."

Note: The role of the auditor is to develop all the facts pertaining to unity. Although a discussion of the distinction between unity of use and unity of operation is being presented to help auditors to recognize when these unities are present, an actual demarcation of the facts between unity of use and unity of operation is not critical at the audit level.

Unity of Operations:

Examples of staff functions that are considered in determining the presence of unity of operations may include functions such as:

- central purchasing;
- manufacture and intercompany sale of products by one corporation to another member of the group for use as supplies, raw materials, component parts, packaging or production equipment;
- sharing of technology or information relating to products produced by the group;
- joint distribution or storage of products;
- transfers of equipment used in the business;
- common advertising;
- centralized accounting, legal, or personnel functions;
- common insurance policies, pension plans or employee benefits; and
- intercompany financing, when such financing serves more than a mere investment function.

This list is by no means considered to be all-inclusive. Furthermore, the auditor must realize that the mere listing of central operating departments will carry little value in the audit report if the taxpayer is successful in arguing that the connections are of little importance. ***The auditor must describe the***

extent of the centralization, and document the benefits derived by the corporate group from the centralized operating departments.

For example, common purchasing might be a very significant unitary factor if the key raw material used by each member of the group is centrally purchased at a substantial volume discount. On the other hand, if the products that are centrally purchased consist only of miscellaneous supplies, the centralization of the purchasing function will carry much less importance.

By the same token, centralized accounting may be significant if a single accounting office performs all of the bookkeeping, tracks and issues statements on all of the receivables, and prepares the payroll for each subsidiary in the group. Often however, the term "centralized accounting" is used to describe a situation where a parent corporation compiles the data to prepare the consolidated Form 1120 tax return and retains the services of an outside accountant to perform the annual audit. These are tasks that are necessarily performed by a single corporation on behalf of virtually any affiliated group, regardless of the level of integration that otherwise exists between the members. Consequently, common tax return preparation and common financial statement preparation will not carry any weight in a unitary context.

Intercompany financing has often been held to be "substantial evidence of unity of operation" (Chase Brass). It is important, however, that the auditor determine the purpose of the financing. As explained in *Tenneco West, Inc. v. Franchise Tax Board* ((1991) 234 Cal.App.3d 1510, 1532), financing is not a unitary factor when it primarily serves to diversify the corporate portfolio and reduce the risks inherent in being tied to one industry's business cycle. The Court distinguished such financing from an investment in subsidiaries which functions to make better use of business-related resources through economies of scale, operational integration, or sharing of expertise. In *Allied-Signal, Inc. v. New Jersey*, (1992) 504 U.S. ___, 119 L.Ed.2d 533, 112 S.Ct. 2251, the U.S. Supreme Court confirmed that capital transactions must serve an operational rather than an investment function.

Taxpayers may argue that the centralized functions performed by one corporation on behalf of another corporation did not result in any cost savings because the service or product could have been purchased for the same price from an outside source. Even if quantifiable cost savings are not present, the corporations may realize intangible benefits from the centralized functions. For example, in the *Chase Brass* decision, the taxpayer purchased approximately 20% of the copper produced by its parent corporation. Although the copper was sold for the same price charged to the taxpayer's competitors, the Court stated, "to have a buyer of a substantial portion of the parent's production throughout the years must be assumed to be an advantage."

In order to anticipate and overcome this argument, the auditor needs to pinpoint the benefits achieved by the centralized function. Although it is difficult to isolate an intangible benefit such as an assured source of supply, documentation of as many facts surrounding the function as possible will help to

demonstrate the benefits and may prevent the taxpayer from minimizing the importance of the function as a unitary factor. For example, the auditor may try to determine why the taxpayer established a particular type of centralized function and how long the function has been centralized in that manner. At the time that a function becomes centralized, there will usually be a good deal of documentation concerning the transition. Corporate minutes, internal correspondence, reports identifying or justifying the need for centralization, and company newsletters are all sources that may reveal the benefits achieved by the centralization.

Unity of Use:

Unity of use relates to executive forces and operational systems. The presence of unity of use is reflected in the integration of executive control over the major policy matters of the business. A centralized executive force will control the direction of the various activities and will ensure that they are operated in a manner that will be most advantageous to the unitary business as a whole. The development of vertical (e.g., manufacturer/distributor) or horizontal (same type of business) relationships in order to maximize the profitability of the group is an example of how common executive control binds the operational systems of the business. Substantial intercompany sales or product flow, or the intercompany transfer of knowledge and know-how also constitute unity of use.

The general operation of a group of affiliates for the benefit of the group as a whole may be contrasted with a situation where common officers and directors are concerned only with maximizing the profitability of each individual corporation but without regard to each corporation's role in the group as a whole.

In order to determine where the major policy matters for each entity in the group are decided, it is necessary for the auditor to look beyond the organization charts. Although the organization charts will identify the chain of command and show the reporting lines from the president down through the business segments, the auditor will need to gain an understanding of the involvement and control that takes place at each level of management. Audit techniques for obtaining this information are discussed in MATM 3500 - MATM 3595.

The three unities test is often easiest to apply in a horizontally integrated enterprise. Since the various segments of the business are engaged in the same activity, they are most likely to have significant centralized staff functions such as centralized advertising or purchasing that are designed to give advantages to the business despite geographic differences (*Chase Brass*).

Reviewed: December 2002

3045 Contribution Or Dependency Test

The Court in *Edison California Stores* stated that unity was present when the operation of the business done within California is dependent upon or contributes to the operation of the business done outside the state.

The contribution or dependency test is most easily satisfied by the presence of intercompany sales of tangible personal property. An example of this would be a parent corporation manufacturing the product that is sold by a subsidiary to customers in this state. However, in *Superior Oil Company*, the court found that contribution or dependency existed with respect to areas that included executive policymaking, coordination of activities, training of personnel, research, financing, and numerous other functions. As can be seen from this decision, the contribution or dependency test is generally based on the same functions and activities used to determine a unitary business under the "operations" and "use" tests.

The contribution or dependency test was clearly endorsed as an alternative test for unity in *A.M. Castle & Co. v. FTB*, Cal. Court of Appeal, 36 Cal.App.4th 1794 (1995). In this case the question was whether a parent company, which sells metal products, was unitary with a subsidiary, which distributes metal alloy shapes. In sustaining FTB's finding of unity, the court stated that this "...is a classic case of a larger parent purchasing a smaller subsidiary to better utilize its existing resources, and to capitalize on the synergy between the two companies." The court considered whether the taxpayer was unitary under the three unities test. It stated that the taxpayer can make "a colorable issue that there was no unity of operation." However, the court decided not to rule on unity of operation, as Castle and Hy-Alloy were unquestionably unitary under the dependency or contribution test. The court also found that there was no constitutional constraint that requires use of the three unities test. The court can apply any test to determine unity as long as there is a flow of value between the segments in question. The Court of Appeal's decision is consistent with [FTB Notice 1992-4](#). [FTB Notice 1992-4](#) stated that unity can be established under any one of the judicially accepted tests, and unity "cannot be denied merely because another of those tests does not simultaneously apply."

Reviewed: December 2002

3050 UNITY OF OWNERSHIP

Unity of ownership is a prerequisite to unity. In order to satisfy constitutional requirements, it is necessary that there be "some bond of ownership or control" uniting the otherwise unitary business (*Container Corporation of America v. Franchise Tax Board*, (1983) 463 U.S. 159, aff'g 117 Cal.App.3d 988 (1981)). Unity of ownership allows the corporations to be commonly controlled in a manner whereby the interests of a single corporation can be made subservient to the interests of the entire unitary group.

Generally, unity of ownership will be present if there is common ownership or control of more than 50% of the voting stock of each corporation (R&TC §25105). The ownership or control may be direct or indirect as shown by the following examples:

Example 1

Corporation A owns 50% of the stock of Corporation B and 25% of the stock of Corporation C. Corporation B owns 50% of the stock of Corporation C.

Corporation A does not own more than 50% of B, and B does not own more than 50% of C. Since A does not have a controlling interest in B, B's shares of C are not indirectly controlled by A. Therefore, A's direct and indirect interests in C are not sufficient to meet the ownership requirement. Unity of ownership is not present with respect to A, B or C.

Example 2

Assume the same facts as in Example #1, except that A now owns 51% of the stock of B. All three corporations would now meet the ownership test. Since A now has a controlling interest in B, it indirectly owns 50% of C through B. When this indirect interest is added to A's 25% direct interest in C, ownership of more than 50% is established.

Example 3

Corporation A owns over 50 percent of the voting stock in Corporations B, C and D. Corporations B, C and D are unitary amongst themselves, but not unitary with Corporation A. Since Corporations B, C and D are commonly owned, the ownership requirement has been satisfied and B, C and D should file on a combined reporting basis even though A will not be included in the combined report. ([FTB Legal Ruling 410](#).)

In the majority of cases, the ownership determination is relatively straightforward. Occasionally, however, issues arise concerning family ownership, joint venture corporations, and other situations for which treatment under the code is not clear-cut. Prior to 1995, California's policy regarding unity

of ownership was based upon the interpretation of (former) §25105 that had evolved over the years through SBE and court decisions. For taxable years beginning on or after January 1, 1995, §25105 was amended to establish a bright-line test for unity of ownership.

Pre-1995 Ownership:

The department's position regarding unity of ownership has shifted several times over the years as conflicting SBE and court decisions have been handed down. Since many of these cases have been overturned or invalidated by subsequent decisions, they can no longer be relied upon as authority in this area.

For many years, the department had advanced the position that unity of ownership required ownership by a single entity of more than 50% of the voting stock of a corporation (the single entity bright-line test). Although two SBE decisions in the 1970s (*Appeal of Shaffer Rentals*, Cal. St. Bd. of Equal., September 14, 1970; and *Appeal of Signal Oil & Gas Company*, Cal. St. Bd. of Equal., September 14, 1970) found effective control in situations where stock ownership did not exceed 50%, since that time the SBE has consistently upheld the single entity bright-line test (*Appeal of Revere Copper and Brass*, Cal. St. Bd. of Equal., July 26, 1977; *Appeal of Hugo Neu-Proler*, Cal. St. Bd. of Equal., June 29, 1982; *Appeal of Douglas Furniture*, Cal St. Bd. of Equal., January 31, 1984; *Appeal of Rain Bird*, Cal St. Bd. of Equal., June 27, 1985; and *Appeal of Envirocal*, Cal St. Bd. of Equal., November 15, 1988.)

In the 1980s, a series of court decisions reversed the SBE holdings:

In *Hugo Neu-Proler International Sales Corp. v. Franchise Tax Board* (1987) 195 Cal.App.3d 326, two unrelated corporations were equal 50% partners in a partnership which owned 100% of a domestic international sales corporation (DISC). Both corporations filed California returns that reported one-half of the net income of the partnership and DISC. The FTB argued that since no single entity owned or controlled over 50% of the DISC, the DISC should be taxed separately. The Court applied principles of attribution and the concept of indirect control developed under IRC §482 to the language of R&TC §25105 ("direct or indirect ownership or control of more than 50% of the voting stock"). Their conclusion was that while neither corporate partner alone had a controlling interest in the DISC, together they had absolute sovereignty over it. Unity of ownership was found to be present between each partner and its proportionate interest in the DISC.

In *Rain Bird Sprinkler Mfg. Corp. v. Franchise Tax Board*, (1991) 229 Cal.App.3d 784, closely related family members owned a majority interest in 18 corporations, but most of the corporations were not owned more than 50% by any one family member. The Court confirmed that R&TC §25105 was the controlling section with respect to ownership requirements for purposes of R&TC §25101. The Court then stated that the statutory language of R&TC §25105 (direct or indirect ownership or control by the same interests) clearly implies a legislative intent that the principles of attribution should apply.

Nothing in the language of that statute required ownership by a single entity, nor precluded the ownership test from being met where ownership is held by members of a closely related group acting in concert. Unity of ownership was found to be present in this case.

In the wake of these decisions, [FTB Legal Ruling 91-1](#) was issued to re-examine the requirements for unity of ownership under R&TC §25105 and to set forth the policy that the department would follow in this area. The points established in the Legal Ruling include the following:

R&TC Section 25105 is acknowledged as the operative section for unity of ownership.

The meaning of "voting stock" is clarified to be that stock which confers the power to control the operations of the corporation through election of the board of directors. Situations involving more than one class of voting stock and transfers of voting rights are also addressed in the Ruling. Some examples may also be found in MATM 3550.

The meaning of direct and indirect ownership and direct and indirect control is defined. The *Rain Bird* concept of control through concerted action is adopted and its application is discussed.

Reliance on IRC §482 practical or economic control principles (cited in *Hugo Neu-Proler* and commented upon with approval in *Rain Bird*) will only be applicable to R&TC §25105 to the extent that the "more than 50%" threshold is met. Also, since the attribution rules of IRC §318 have not been expressly incorporated into R&TC §25105, they have no application to that section. The *Hugo Neu-Proler* decision shall only be applied in situations with substantially identical facts.

For taxable years beginning before January 1, 1995, [Legal Ruling 91-1](#) reflects the current department policy with respect to unity of ownership.

Taxable years Beginning On or After January 1, 1995:

For taxable years beginning on or after January 1, 1995, R&TC §25105 was amended to re-establish a bright-line test for unity of ownership. Following is an overview of the new ownership requirements. For detailed explanations and definitions relevant to an ownership determination, auditors should refer to the statute.

Ownership requirements for combined reporting will only be met with respect to corporations that are members of a "commonly controlled group," defined as follows:

A group of corporations that is connected through stock ownership (or constructive ownership) with a parent corporation. This criterion will be met if the parent owns more than 50% of the voting stock of at least one corporation, and if more than 50% of the voting stock of each other corporation is cumulatively owned by the parent and/or by another corporation that meets the ownership

requirements. (Examples #1 and #2 in the first part of this MATM section are illustrative of how this rule works.)

Any two or more corporations whose voting stock is owned (or constructively owned) more than 50% by one person. (Corporations are included in the definition of "person" found in R&TC §25105(f)(2).)

Any two or more corporations that constitute "stapled entities" as defined in R&TC §25105(b)(3).

Any two or more corporations whose voting stock is owned (without regard to family constructive ownership rules) by members of the same family. An exception to this rule may be made if the taxpayer establishes that the family ownership does not constitute direct or indirect control by the same interests, within the meaning given to that term in IRC §482.

If a corporation is eligible to be treated as a member of more than one commonly controlled group under these rules, then it must elect one group with which to be recognized as a member. Once the election is made, it will remain in effect unless revoked with the approval of the FTB. If a corporation, which was a member of a commonly controlled group, ceases to meet the ownership requirements for a period of time, but meets the requirements again within two years, the FTB may treat that corporation as a member of the commonly controlled group for the entire time.

Reviewed: September 2003

3060 UNITARY INDICATIONS UNDER REG §25120(b)

CCR §25120(b) provides guidance regarding what is considered to be a unitary business. Most significantly, the Regulation sets forth three factors, the presence of any one of which will create a strong presumption that the activities of the taxpayer constitute a single trade or business. These factors are as follows:

"(1) Same type of business: A taxpayer is generally engaged in a single trade or business when all of its activities are in the same general line. For example, a taxpayer, who operates a chain of retail grocery stores, will almost always be engaged in a single trade or business.

"(2) Steps in a vertical process: A taxpayer is almost always engaged in a single trade or business when its various divisions or segments are engaged in different steps in a large, vertically structured enterprise. For example, a taxpayer which explores for and mines copper ores; concentrates, smelts and refines the copper ores; and fabricates the refined copper into consumer products is engaged in a single trade or business, regardless of the fact that the various steps in the process are operated substantially independently of each other with only general supervision from the taxpayer's executive offices.

"(3) Strong centralized management: A taxpayer which might otherwise be considered as engaged in more than one trade or business is properly considered as engaged in one trade or business when there is a strong central management, coupled with the existence of centralized departments for such functions as financing, advertising, research, or purchasing. Thus, some conglomerates may properly be considered as engaged in only one trade or business when the central executive officers are normally involved in the operations of the various divisions and there are centralized offices which perform for the divisions the normal matters which a truly independent business would perform for itself, such as accounting, personnel, insurance, legal, purchasing, advertising, or financing."

The SBE discussed the application of this Regulatory presumption in *Appeal of Sierra Production Service, Inc.*, Cal. St. Bd. of Equal., September 12, 1990. When the party seeking the benefit of the presumption establishes by "specific, concrete evidence" that one of the CCR §25120(b) factors apply, then the business is presumed to be unitary. This presumption may be rebutted, but the burden is on the opposing party to demonstrate "concrete evidence sufficient to support a finding that a single integrated economic unit did not exist." In other words, the presumption may only be overcome with evidence that the activities are not unitary under any of the established tests (e.g., three unities, contribution or dependency). If the presumption is successfully rebutted, then it disappears, and the burden shifts back to the party seeking combination to provide evidence to compel a determination that a unitary business exists. In [FTB Notice 1992-4](#), the department acknowledged that it is following these procedures for applying the presumption.

The fact that a taxpayer does not meet any of the three factors under CCR §25120(b) simply means that no presumption of unity applies. No presumption of non-unity is created.

Reviewed: December 2002

3065 Same Type Of Business

The regulation uses a chain of grocery stores as an example of activities that are in the same line of business. In practice however, various activities may have similarities, but may not be as identical as a chain of grocery stores. In the following decision, the California Court of Appeal expressed their interpretation of what it takes for two corporations to be engaged in the same type of business:

In *A.M. Castle & Co. v. FTB*, 36 Cal.App.4th 1794 (1995), the parent company's (Castle's) business involved buying bulk metals from various mills, and then warehousing and processing those metals for resale to industrial customers. The parent acquired a subsidiary (Hy-Alloy), which distributed specialty metal alloy shapes. In arguing that the Castle and (Hy-Alloy) were not in the same general line of business, the taxpayer relied on SBE decisions which construed 'activities in the same general line' in an extremely narrow manner (*Appeal of Doric Foods Corporation*, Cal. St. Bd. of Equal., December 5, 1990, and *Appeal of Mohasco Corporation*, Cal. St. Bd. of Equal., October 14, 1982). The Court pointed out that precedents made by administrative tribunals such as the SBE do not bind them. But even if the cited decisions did have precedential value, the Court indicated that it would decline to follow them.

The Court then expressed its view that "two corporations are engaged in the same 'general line' of business when: (1) the two businesses are similar (but not necessarily identical); and (2) after the two corporations are combined, it permits the parent corporation to make better use of its existing business related resources. This may be done through 'economies of scale,' 'operational integration,' or 'sharing of expertise.'"

In this case, the acquisition of Hy-Alloy "permitted Castle to use its existing distribution system to service a new (though closely related) market." Therefore, the Court found that Castle made "better use of its existing business related resources" when it purchased Hy-Alloy.

The following SBE decisions also provide some guidance in determining what is considered the "same type of business":

CAUTION: The *Appeal of Doric Foods Corporation*, Cal. St. Bd. of Equal., December 5, 1990, had contained a discussion of the SBE's interpretation of the term 'same line of business.' This decision has since been de-published, and should not be cited. Furthermore, the California Court of Appeals declined to follow the SBE's interpretation of "same general line of business" expressed in *Doric Foods* and *Appeal of Mohasco Corporation*.

The *Appeal of Unitco, Inc.*, Cal. St. Bd. of Equal., June 21, 1983, involved a taxpayer that was engaged in the rental of improved real property. The taxpayer's investments included rentals of warehouses, office buildings, an apartment building, a shopping center, a bowling alley operation,

and two real estate partnerships. Although the taxpayer had managed its properties in the past, by the appeal years another company was managing the properties for a fee. During the appeal years, the taxpayer's three officers played a very limited role in the decision-making for the properties.

The FTB sought to combine the various rental activities into a single unitary business, stating that the case presented a vivid example of a single corporation engaged in identical activities in four separate states, totally dependent upon the three officers to make the major policy decisions and, in some cases, to provide day-to-day guidance. The FTB also emphasized that where a taxpayer is engaged in the same type of business, a strong presumption of unity is created. The SBE disagreed, finding that each rental activity was separate and distinct.

"In no way do any of appellant's rental activities contribute to or depend upon any of the others for their success or failure. Due to the disparate nature of each of appellant's property interests and the lack of any significant common relationship between them, we cannot conclude that these activities constitute a single economic unit."

The SBE dismissed the FTB's arguments with respect to the CCR §25120(b)(1) presumption, stating, "the simplest answer to this contention is that the presumption is not conclusive. When read in its entirety, the record will not support a conclusion that appellant's rental activities constitute a single unitary business."

The *Appeal of The Hearst Corporation*, Cal. St. Bd. of Equal., June 18, 1992, was another case in which the taxpayer successfully overcame the CCR §25120(b)(1) presumption. The taxpayer was engaged in various businesses such as television and radio broadcasting, cable communications, real estate, and the publication of newspapers, books and magazines such as *Cosmopolitan* and *Good Housekeeping*. A wholly owned subsidiary of the taxpayer operating in the United Kingdom also published books and magazines, including U.K. editions of *Cosmopolitan* and *Good Housekeeping*. Pursuant to a licensing agreement, the taxpayer received royalties from the U.K. subsidiary for *Cosmopolitan* sales. The U.K. subsidiary was locally managed, had its own editorial staff, and its own accounting, advertising, legal, purchasing, insurance and marketing divisions. The cover designs, layouts and photographs for the magazines were done separately. Although the U.K. subsidiary was entitled to use material published in the U.S. edition of *Cosmopolitan*, less than 4% of the U.K. articles consisted of the U.S. material. Common advertisements and intercompany sales were minor.

The SBE was not persuaded by the similarities in format between the U.S. and the U.K. editions of *Cosmopolitan* and *Good Housekeeping*. While portions of the publications were similar, the same format was also used by a number of similar magazines published by competitors and other unrelated companies. The taxpayer had demonstrated that very few ties existed between the U.S. and U.K. operations, and there was no evidence that the contributions and dependencies that commonly exist between similar activities were present in this case. The SBE concluded that the "same line of

business" presumption had been overcome, and that the U.S. and U.K. operations were operated as independent, nonunitary operations.

In the *Appeal of Quaker State Oil Refining Corporation* (Cal. St. Bd. of Equal., October 6, 1987), the SBE also commented upon whether the taxpayer was in the same business as its subsidiary although the CCR §25120(b)(1) presumption was not applied. Because of lack of evidence of commonality of operations or transferability of technology between the activities, the SBE did not find activities in superficially similar businesses to be unitary.

Reviewed: December 2002

3070 Steps In A Vertical Process

In a vertically integrated enterprise, various components of the business perform successive steps necessary to produce a finished product. The Regulation contains an example of a taxpayer, which explores for and mines copper ores, and performs the processes necessary to transform that ore into consumer products. Other examples would be an integrated oil company; or a timber company which cuts and logs timber, mills the lumber, makes plywood and other products, and sells the finished lumber products. In the following case, vertical integration took the form of a soft drink concentrate manufacturer that acquired a bottler and distributor of its products:

In *Appeal of Dr Pepper Bottling Company of Southern California, et al.*, Cal. St. Bd. of Equal., December 5, 1990, the taxpayer produced, bottled, canned and distributed soft drinks, including Dr Pepper. The taxpayer was acquired by Dr Pepper Company (DPC), a company which manufactured, marketed, sold and distributed nationwide soft drink concentrates and syrups, primarily Dr Pepper and sugar-free Dr Pepper. Over 50% of the taxpayer's concentrate and syrup purchases were from DPC, and more than 50% of the taxpayer's sales were of Dr Pepper soft drink products. The taxpayer argued that the taxpayer was not unitary with DPC, and attempted to minimize the importance of its intercompany sales by pointing out that the sales amounted to only 1% of DPC's total annual sales, and only 9-13% of the taxpayer's total purchases.

Citing *John Deere Plow Co. v. Franchise Tax Board* ((1951) 38 Cal.2d 214) and CCR §25120(b)(2), the SBE observed that the taxpayer's arguments ignored the fact that a vertically integrated business enterprise has consistently been regarded as a classic example of a unitary business. The Dr Pepper syrup was an essential component for a product, which made up a substantial part of the taxpayer's sales, and the taxpayer could not get that syrup from any other source. Also, the taxpayer provided an outlet for DPC's product. The SBE found that the fact that DPC maintained similar licensing agreements with 500 different bottlers (most of which was not company owned) did not diminish the unitary significance of the arrangement. Basing their decision primarily on the existence of vertical integration, the SBE sustained the FTB's determination that the companies were unitary.

Reviewed: December 2002

3075 Strong Centralized Management And Centralized Departments

A taxpayer seeking the benefit of the CCR §25120(b)(3) presumption must establish the presence of both "strong centralized management" and "centralized departments" for such functions as financing, advertising, research or purchasing. In footnotes to its decision in *Appeal of Sierra Production Service*, the SBE discussed its interpretation of these terms:

"5/ What constitutes 'strong central management' will depend, to a considerable extent, on the facts in the particular case. We can say, however, that it requires more than the mere existence of 'common officers or directors' or an allegation that the various business segments were under the ultimate control of the same person or group of people. The regulation clearly contemplates that the central managers will, among other things, play a regular operational role in the business activities of the various divisions or affiliates. The significance of such a managerial role, in the constitutional context, was underscored by the Supreme Court in *Container*."

"6/ There is no question that the regulation does not contain an all-inclusive list of the services which might be centralized, and which might provide evidence of unitary integration. Similarly, it should be clear that proof of a 'centralized department' requires something weightier than merely alleging, for example, that there was a 'common accountant' who kept the books for each affiliate. Other trivialities like a 'common insurance agent' will likewise be insufficient."

Unlike the first two presumptions, the CCR §25120(b)(3) presumption may be applied to diverse businesses that do not exhibit the more measurable indicators of unity such as intercompany product flow or sharing of product-related knowledge and expertise. In recent years, a great deal of controversy has surrounded the application of this presumption.

The following string of cases has shaped the department's approach for dealing with the CCR §25120(b)(3) presumption:

Appeal of Sierra Production Service, Inc., et al., Cal. St. Bd. of Equal., September 12, 1990, involved the decombination at audit of an oil and gas well-servicing firm and a general aviation sales and service firm. The FTB's position was that the lack of "functional integration" between the companies precluded a unitary determination. The SBE found the companies to be unitary based upon evidence of mutual interdependence and flows of value sufficient to establish that the companies were a "single integrated economic enterprise," rather than on the basis of the CCR §25120(b)(3) presumption. Notwithstanding this fact, the decision is important in the context of the (b)(3) presumption because of the relationship that the SBE found between that presumption and the combination of diverse businesses.

Specifically, the SBE disagreed with the implication that diverse businesses are presumptively nonunitary if "functional integration" is lacking. The SBE stated that the (b)(3) presumption operates to put diverse businesses with strong central management and centralized departments on equal footing with affiliated entities engaged either in the same general line of business or in different steps in a large, vertically structured enterprise.

In *Mole-Richardson Company v. Franchise Tax Board* (1990) 220 Cal.App.3d 889, the taxpayer was primarily engaged in the design, manufacture, rental and sale of specialized lighting equipment in California, but also had farm and ranch operations in Colorado. Although the operations of these businesses were not integrated, the Court concluded that the companies were nonetheless "functionally integrated" and entitled to file a combined report.

The Court found that the evidence in the case "established that respondent had a strong centralized management in that all major business decisions were made by Warren K. Parker. All accounting, payroll, insurance, pension plans, primary banking, major purchasing and advertising for the Colorado business as well as the California business was conducted at the Hollywood offices. In managing certain operations from one location the enterprise was able to realize cost savings, resulting in economies of scale. Real property in Hollywood was mortgaged to fund improvement of the ranch property in Colorado. One California attorney acted as general counsel for all businesses . . . We are satisfied that based on the evidence in this case the operations of respondent were functionally integrated and respondent was entitled to tax treatment as one unitary business."

This was the first major "diverse business" decision, and it established that activities could be unitary based upon strong centralized management and centralization of non-operational functions.

In *Dental Insurance Consultants, Inc. v. Franchise Tax Board*, (1991) 1 Cal.App.4th 343, the issue was unity between a corporation (DIC) primarily engaged in providing review and advice regarding dental insurance claims for various insurance companies, and its wholly-owned subsidiary which operated a number of small farms. With one exception, the officers and directors of the farm subsidiary also served as officers and directors of DIC. Functions such as accounting, bookkeeping, purchasing insurance, and check-writing services were provided to the farm subsidiary by DIC. DIC lent the farms money, and provided guarantees for a number of farm obligations. Although unrelated management firms conducted the daily operations of the farms, the ultimate policy decisions were the responsibility of the common directors. The president and majority shareholder of DIC, Richard Guenther, had an active role in the farm operations. He approved all checks issued by the farms, and approved such decisions as deepening a well, repairing wind machines, establishing the mix of a product and installing a drip irrigation system. Guenther and another common officer negotiated and executed the farm management agreements. Guenther also applied for water delivery on behalf of the farms, and executed an agreement with the irrigation district regarding the installation of a pump.

The Court found the management role played by DIC and Guenther to be much more than the occasional oversight any parent routinely gives to an investment in a subsidiary. Therefore, even though independent management firms performed the daily activities of the farms, the Court concluded that the farms were not operated independently. "The close control by DIC and the shared administrative functions, coupled with undisputed unity of ownership, establish the requisite economic, operational and managerial interdependence to establish the unitary nature of these businesses." This decision indicates that strong centralized management can exist even though the day-to-day management is independent.

In contrast, the Court in *Tenneco West, Inc. v. Franchise Tax Board* found that strong centralized management did not exist. The taxpayer had asserted that Tenneco and its subsidiaries were engaged in a single unitary business. The FTB had conceded that Tenneco was unitary with its oil-related subsidiaries, but determined that unity did not exist with respect to the remaining subsidiaries (excluded subsidiaries). The excluded subsidiaries were engaged in various activities, including shipbuilding, packaging, and manufacturing of automotive parts and construction equipment.

In numerous public documents, policy manuals and speeches, Tenneco had portrayed their operations as autonomous and highly decentralized. Although some centralization existed with respect to various functions, the Court found the substance of that centralization to be minimal. For example, although Tenneco had a legal department, each of the major divisions also had its own legal staff. Tenneco's tax department handled federal, ad valorem and property tax matters, but each subsidiary filed its own state tax returns. The subsidiaries' handled their own accounting and financial activities although those activities were reviewed and periodically audited by Tenneco's central accounting and internal audit departments.

The taxpayer attempted to establish strong centralized management through Tenneco's policy control, the Court found that control to be neither strong nor uniform. The Court stated:

". . . most of Tenneco's business strategy and activities -- including the annual planning process, weekly meetings between the chief executive officer and executive committee, internal audit, corporate-wide procedures manual, financial strategy with debt targets and dividend payout ratios, approval of major capital expenditures, external financing, cash management, real property disposition, guaranties, loans and advances to and from divisions, insurance, and overruling subsidiaries' ideas -- constituted 'the kind of behavior that one would expect to find in any parent subsidiary or parent division relationship'."

Since strong centralized management and centralized departments were not present, the CCR §25120(b)(3) presumption of unity did not apply. The Court went on to find that the activities of the Tenneco excluded subsidiaries were not so integrated with Tenneco's oil related businesses or with each other so as to constitute a unitary business.

Although the courts have not provided a precise definition of strong centralized management, the current court and SBE decisions appear to focus on involvement of managers in significant operational decisions with some regularity. This regular operational role may be distinguished from a lesser degree of management oversight over the results of a subsidiary's operations that is to be expected of any parent/subsidiary relationship. In order to determine whether there is strong centralized management, auditors must first acquire an in-depth understanding of the functions of the businesses under examination. The major operations of the businesses must be defined, and the major decisions affecting those operations must be identified. Then, the auditor must identify the purported central managers and determine whether and to what extent those managers were involved in the major operational decisions of the businesses under examination.

In addition to commenting upon centralized management, the cases summarized above also discuss the unitary significance of "centralized departments" in the context of the CCR §25120(b)(3) presumption. The following references to the issue may also be instructive:

In the *Appeal of Hollywood Film Enterprises*, Cal. St. Bd. of Equal., March 31, 1982, at 665 [3 SBE 664, 665]), the State Board of Equalization stated:

‘[W]here there is no horizontal or vertical integration, some of the most significant unitary factors, such as intercompany product flow, often will not exist. Therefore, factors, which might be considered relatively insignificant in a case of horizontal or vertical integration, take on added importance because they are the only factors present to consider. Each case must be decided on its own particular facts....’

In the *Appeal of Saga Corporation*, Cal. St. Bd. of Equal., June 29, 1982, the State Board of Equalization states:

‘[A]ppellant, rather than respondent, bears the burden of proof, i.e., appellant must establish by a preponderance of the evidence that the unitary connections present in the case are, in the aggregate, so trivial and insubstantial as to require a holding that a single unitary business did not exist.’

In *F.W. Woolworth v. Taxation & Revenue Dept.*, 458 U.S. 354 (1982), the U.S. Supreme Court, in finding that related retailing operations were not unitary, stated inter alia:

‘The Woolworth parent did not provide 'many essential corporate services' for the subsidiaries and there was no 'centralized purchasing office...whose obvious purpose was to increase overall corporate profits through bulk purchases and efficient allocation of supplies among retailers.’ (458 U.S. at 370.)

In discussing the unitary significance to be attached to the fact that Woolworth's published financial statements, such as its annual reports, were prepared on a consolidated basis, the high court cited to

the following passage from Keesling and Warren, *The Unitary Concept in the Allocation of Income*, 12 Hastings L.J. 43, 52 (1960):

‘Central accounting, for instance, may result in some savings, but in most instances the amount is trifling in comparison with the income [involved]. Alone considered it is too weak a connecting link to bind into one business, what would otherwise, from an operational standpoint, be considered separate businesses.’ (458 U.S. at 368, fn.22)

In view of the above authorities, there is no single, universally applicable listing of centralized departments rising to unitary significance. Therefore, each case must turn on its particular facts. As a general guide, the following list can assist the auditor in evaluating the centralized department issue. This list is not exhaustive; nor is the absence of any item cited in the list as generally significant or important conclusive of whether a particular case satisfies the element of centralized departments under CCR §25120(b)(3):

Generally Insignificant:

- Preparation of audited financial statements
- Preparation of tax returns
- Common purchases of insurance
- Centralized purchasing of office supplies
- Group discounts on items such as rental cars
- Legal services for matters such as SEC filing, shareholder relations, and public relations.

Generally Significant:

- Government relations (e.g. representing businesses to government regulatory entities)
- Centralized bookkeeping
- Pension and profit sharing
- Cash management, centralized borrowing or treasury
- Personnel: hiring, EDP and payroll
- Employee benefits
- Legal services for contract review
- Common headquarters building
- Labor relations
- Marketing and common use of logo (unconnected to common sales efforts)
- Central advertising offices (providing separate advertising services to each member, without common advertising of a product relationship between products of different members)
- Real estate construction
- Self-insurance

Generally Important:

The information provided in the Franchise Tax Board's internal procedure manuals does not reflect changes in law, regulations, notices, decisions, or administrative procedures that may have been adopted since the manual was last updated

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- Research and development
 - Central purchasing of raw materials
 - Shared sales force
 - Use of common trade name substantially affecting customer purchasing decisions
 - Common distribution systems
 - Common inventory control

FTB Notice 1992-4:

The department has developed diverse business audit guidelines to conform the department's use of the CCR §25120(b) presumptions to the decisions in *Sierra Production Service*, *Mole-Richardson*, *Dental Insurance Consultants*, and *Tenneco West*. These guidelines have been published in [FTB Notice 1992-4](#). The key points are as follows:

The tests for evaluating unity in diverse business cases are the same judicially established tests used for any other unitary determination (e.g., three unities, dependency or contribution, etc. -- see MATM 3030).

If strong centralized management and centralized departments are present, unity cannot be denied solely because of a lack of operational (functional) integration.

A unitary analysis must be based on evidence. While it may be useful to contrast the facts from one case to another, no two cases will ever be identical. Descriptive terms such as "strong centralized management" or "same type of business" are merely labels, and resolution of the unitary issue should turn on an application of the established tests to the unique facts of each case.

The CCR §25120(b) presumptions of unity are important, but not conclusive, considerations in determining unity. The presumptions may be rebutted, and this topic is discussed in more detail in MATM 3060.

The Court of Appeals decisions in *Mole-Richardson* and *Dental Insurance Consultants* are controlling of the diverse business issue. To the extent that SBE decisions are not in accord with these court cases, the SBE decisions should not be relied upon.

For further information relating to the evaluation of strong central management, see MATM 3570. That section also lists sources of information that may be useful in developing this issue

Reviewed: December 2002

3080 UNITARY COMBINATION OF HOLDING COMPANIES

A holding company may be entirely passive, or may provide management and oversight functions to its subsidiaries. In either case however, the activities of the holding company are generally limited. There are no unique unitary tests designed for holding companies; the standard unitary tests (e.g., three unities, contribution/dependency) must be applied. Because those tests were designed to fit the fact patterns that are typically found in operating companies however, their application to holding company fact patterns is not always readily apparent. Two 1995 legal rulings (discussed below) define the department's position with respect to certain fact patterns involving holding companies. In cases, which do not fall within those fact patterns, the auditor needs to carefully analyze the facts and circumstances of the case and determine the relative significance of the flows of value that can be identified.

Following are summaries of the decisions that are most influential in shaping FTB's current policy towards holding companies.

In *Appeal of Fibreboard Corporation*, Cal. St. Bd. of Equal., January 6, 1987, the parent operating company held a holding company, which, in turn, held another operating company. The parent sold the stock of the holding company, and the issue was whether the gain from the sale should be business or nonbusiness. In this particular case, the taxpayer was unable to establish that the two operating companies were engaged in a unitary relationship, therefore the gain was held to be nonbusiness. What is relevant in this context however, is the analysis that the SBE used to reach their conclusion.

Although the gain arose from the sale of the holding company stock, the SBE noted that the real issue was the lower tier operating company's relationship with the parent. The SBE's analysis focused upon whether the holding company stock "*or the assets it represented*" were integrally related to the parent's unitary business operations. Thus, the SBE apparently looked through the holding company to characterize the gain on the sale of holding company stock.

In *Appeal of Lakeside Village Apartments, Inc.*, Cal. St. Bd. of Equal., July 30, 1992, a holding company acquired an apartment complex through a merger with a subsidiary that had been formed for that purpose. The holding company also held a group of other subsidiaries, Reliable Stores, which were engaged in activities entirely unrelated and dissimilar to those of the apartment subsidiary. The officers and directors of the former apartment corporation remained as officers and directors of the new corporation after the merger, and also joined the board of directors of the holding company. The apartment subsidiary paid \$25,000 annually pursuant to an agreement whereby they were required to look to the holding company for decisions regarding financial activities, tax matters and accounting policies. The terms of the agreement also stated that the holding company was to provide certain centralized functions to its subsidiaries on the basis that their activities were viewed

as a "single unitary group." As a result of a successful condominium conversion, the apartment subsidiary distributed \$5 million in dividends to the holding company.

The taxpayer failed to establish that the former officers of the apartment complex had managed anything other than the condominium conversion operations, just as they had done before the acquisition. The other officers and directors of the holding company had no involvement with the apartments, and their financial decision making power was insufficient to support a finding of unity since it was the type of occasional oversight that any parent gives to an investment in a subsidiary. The SBE questioned the credibility of the management agreement since it did no more than outline the types of decisions that any parent makes for its subsidiaries, and seemed to serve no other purpose than to create apparent evidence of unity. The "intercompany financing" asserted by the taxpayer actually consisted only of the payment of dividends from the apartment subsidiary to the holding company, and was rejected as a unitary feature. The SBE concluded that the holding company and the apartment subsidiary were not unitary.

Note that unity between the holding company and its Reliable Stores subsidiaries was not addressed in this case.

The operating company in Appeal of PBS Building Systems, Inc. and PKH Building Systems, Inc., Cal. St. Bd. of Equal., November 17, 1994, was found to be unitary with its holding company parent. The holding company was formed as a vehicle for a leveraged management buyout of the operating company's stock. The operating company made an interest-free loan to the holding company to fund the stock purchase. The holding company later refinanced the debt by issuing securities guaranteed by the operating company. The holding company also obtained a covenant not to compete from the former owners of the operating company.

The SBE emphasized that the standard unitary analysis (the three unities and contribution/dependency tests) is to be applied in determining whether a holding company and operating company are unitary. They rejected the generalization that "holding companies are essentially inactive and are per se incapable of providing or receiving a flow of value to or from an operating company." Instead, the SBE observed that since the typical characteristics of unity may not exist, the holding company context requires a focus on the economic realities of the particular corporate structure to determine whether unity is present. Citing *Appeal of Hollywood Film Enterprises* (Cal. St. Bd. of Equal., March 31, 1982), the SBE stated: "Factors which might be considered relatively insignificant in a case of horizontal or vertical integration take on added importance because they are the only factors present to consider."

The flows of value that the SBE found in this case included intercompany financing of substantial value to the holding company, substantial amounts of money expended by the operating company for the holding company's public debt offering, and the covenant not to compete entered into by the holding company to protect the operating company from its former owner. The complete overlap of

officers and directors, when considered in light of the other integrating factors, was seen as further evidence of the operation of the companies as a unitary business. The SBE concluded that there was substantial evidence to support a finding of unity.

The *Appeal of National Silver Co.*, Cal. St. Bd. of Equal., October 28, 1980, and *Appeal of Allright Cal., Inc.*, Cal. St. Bd. of Equal., January 9, 1979, both involved situations where the holding companies provided services for their subsidiaries, and were found by the SBE to be part of the unitary business. On the other hand, in *Appeal of Power-Line Sales, Inc.*, Cal. St. Bd. of Equal., December 5, 1990, and *Appeal of Insul-8 Corporation*, Cal. St. Bd. of Equal., April 23, 1992, the SBE did not allow the holding companies to be included in the unitary group on the basis that the taxpayers had failed to meet their burden of proving a unitary relationship.

In November 1995, the department issued [Legal Ruling 95-7](#) and [Legal Ruling 95-8](#) explaining the department's position on combination of holding companies with operating companies in light of the SBE's opinion in the *Appeal of PBS/PKH*. [Legal Ruling 95-7](#) deals with fact patterns in which a passive parent holding company holds one or more operating company subsidiaries, which are engaged in a single unitary business with each other. [Legal Ruling 95-8](#) deals with fact patterns in which an intermediate passive holding company is held by a parent operating company and in turn holds one or more operating company subsidiaries, which are engaged in a single unitary business with the operating company parent. The rulings announce a broad rule of combination in the fact patterns described. Combination of passive holding companies in other fact patterns will depend upon the facts and circumstances of the case.

Legal Ruling 95-7 “Parent Holding Company”

[FTB Legal Ruling 95-7](#) describes three fact patterns. In Situation 1, a passive parent holding company holds an operating company engaged in a single unitary business. In Situation 2, a passive parent holding company holds two operating company subsidiaries engaged in a single unitary business with each other. Situation 3 differs from Situation 2 in one respect: the holding company is held by an operating company which is not engaged in a single unitary business relationship with the holding company's operating company subsidiaries. In each situation the holding company dedicates virtually all of its activity to its operating subsidiary or subsidiaries.

L.R. 95-7 holds that in all three situations the holding company is unitary with and includable in a combined report with its operating company subsidiaries, but that in Situation 3, the holding company's operating company parent is not includable in the combined report.

The ruling applied the Edison California Stores contribution or dependency test articulated in the general provisions of CCR §25120(b) and in the SBE's decision in *Appeal of PBS/PKH*. It references PBS/PKH and the U.S. Supreme Court opinion in *Mobil Oil Corporation v. Commissioner of Taxes* (1980) on the importance of looking to the underlying economic realities in determining the propriety of apportionability. It also references the SBE's analysis in *Fibreboard Corporation* (1987), where the

SBE looked through an intermediate holding company and focused on the absence of a unitary relationship between the holding company's operating company parent and operating company subsidiary.

Applying the above principles, LR 95-7 concludes that when a passive parent holding company holds one or more operating company subsidiaries which are engaged in a single unitary business with each other, the holding company's primary function is as a conduit between the shareholders and the single unitary business operations they indirectly own. The unitary business is what gives the holding company value to the shareholders. The holding company represents the unitary company or group. It thus is an integral part of a unitary system, the parts of which contributes to or depends upon each other. Separating the holding company from the unitary operating company or group for combined reporting purposes places too much emphasis on form, when in substance there is but one unitary business. That underlying economic reality is not altered when, as in Situation 3, a nonunitary operating company holds a majority of the holding company's stock as a nonbusiness asset.

Legal Ruling 95-8 "Intermediate Holding Company"

[Legal Ruling 95-8](#) describes two fact patterns. In Situation 1, an intermediate passive holding company holds a single operating company subsidiary that is engaged in a single unitary business with the holding company's operating company parent. In Situation 2, an intermediate passive holding company holds two operating company subsidiaries, which are engaged in a single unitary business with the holding company's operating company parent. In each situation, the holding company dedicates virtually all of its activity to the operating company parent and subsidiary or subsidiaries.

[Legal Ruling 95-8](#) holds that in both situations the holding company and operating companies are unitary and includable in a combined report with each other.

[Legal Ruling 95-8](#) builds upon the reasoning of [Legal Ruling 95-7](#). It applies the Edison California Stores contribution or dependency test, the economic realities principles articulated in Mobil Oil Corporation and PBS/PKH and the "look through" analysis of Fibreboard. In addition it cites *Appeal of Monsanto Co.*, Cal. St. Bd. of Equal. (1970) and its progeny and the U.S. Supreme Court opinion in *Barclay's Bank v. Franchise Tax Board* (1994) for the proposition that the unitary relationship between corporations included in a combined report may be indirect.

LR 95-8 concludes that when an intermediate passive holding company owns one or more operating company subsidiaries, which are unitary with the holding company's operating company parent, the holding company's primary function is as a conduit which effectuates contributions or dependencies between the parent and the subsidiaries. The holding company performs a unitary function for the group by holding the stock of the lower tier operating company subsidiary or subsidiaries which would be a unitary business asset of the parent operating company if it were directly held by the parent.

The holding company dedicates virtually all of its activity, however small, to the parent and subsidiary or subsidiaries. It is an integral part of a larger unitary system, the parts of which contributes to or depends upon each other. To separate the holding company for combined reporting purposes places too much emphasis on the form of corporate structure when the substance and underlying economic reality is that there is but one unitary business.

Holding companies, which own non-unitary subsidiaries:

The department has announced that it will continue to follow the *Appeal of Lakeside Village Apartments*, Cal. St. Bd. of Equal. July 30, 1992. In *Lakeside Village* the SBE denied combination of a passive parent holding company with operating company subsidiaries, which were not unitary with each other. In contrast to the fact patterns presented in *PBS/PKH* and *LR's 95-7* and *95-8*, in *Lakeside Village* there were two lines of business: an apartment concern and a retail stores concern, and there was no showing of unity between those two concerns or of unitary linkage through strong central management and centralized departments.

Reviewed: September 2003

3085 INSURANCE COMPANIES

Insurance companies may not be included in the combined report.

The California Constitution (Article 13, §28) generally provides for a tax based on gross premiums of most insurance companies doing business in California. Subdivision (f) of that section provides that with the exception of taxes on real estate and motor vehicles, the gross premiums tax "is in lieu of all other taxes and licenses, state, county and municipal, upon such insurers and their property." The courts have held that this language effectively exempts insurance companies from the California franchise tax (*First American Title Insurance & Trust Co. v. FTB* (1971) 15 Cal.App.3d 343[93 Cal.Rptr. 177]). [FTB Legal Ruling 385](#) (1975) explains that under authority of Article 13, §28, a corporate insurer operating in California is barred from inclusion in a combined report, even if it is unitary. To accord uniform treatment on basically similar facts, the legal ruling goes on to state that it will be the department's practice to exclude from the combined report any insurance company operating entirely outside California. This exclusion from the combined report applies to companies that are regularly engaged in an insurance business, and that are licensed as such and subject to regulation under the laws of the state(s) where they operate.

Before 1938, insurance companies were taxed on their gross premiums less amounts paid for reinsurance. The insurance company receiving the reinsurance premiums would pay tax on its premiums. State taxation of insurance companies was changed effective for 1938, in that insurance companies were taxed on their gross premiums without reduction for reinsurance premiums paid. Thus, reinsurance was not taxable on the basis that the insurance premiums had already been indirectly taxed. Accordingly, reinsurance companies are subject to the provisions of §28, and are therefore exempted from the franchise or income tax. (For an explanation of reinsurance, see MATM 5190.)

Note that an insurance company, which is excluded from the combined report under the California constitution, may still be unitary with or functionally related to its affiliates. The SBE has held that the stock of a unitary insurance company was integrally related to the unitary business operations of the corporate group even though the insurance company could not be included in the combined report. Therefore, the dividends received from the insurance company subsidiary were held to be business income. (*Appeal of Control Data Corp., Commercial Credit Corp.*, Cal. St. Bd. of Equal., February 22, 1996.)

See MATM 5190 for a discussion of captive insurance companies.

Reviewed: September 2003

3090 INSTANT UNITY

Occasionally, the issue is not whether entities are unitary, but when they became unitary. When a corporation acquires another corporation, a period of time often elapses before enough ties are established between the activities to constitute unity. The following SBE decisions illustrate some of the factors that may affect determinations in this area:

In *Appeal of Atlas Hotels, Inc. and Picnic 'n Chicken, Inc.*, a taxpayer engaged in a unitary hotel business acquired a corporation that owned and operated a chain of fast food outlets. Immediately upon acquisition, two of the hotel's top executives assumed positions as the two top executives of the fast food company, and began to run the day-to-day operations. Although ten-year employment agreements were signed with several of the top fast food executives as part of the purchase agreement, the duties of these "holdover" managers were restricted and their authority was very limited. Substantive changes to the overall operating philosophy of the fast food chain were immediately instituted, and several service functions were combined for the hotel and fast food operations. Since many of these managerial and operational changes were in the planning stage well before the actual acquisition date, implementation of the changes was commenced immediately upon acquisition. The FTB argued that the integration between the entities was not sufficient to demonstrate unity until the following year when the holdover management was discharged and the intercompany exchanges became more active. The SBE disagreed, and concluded that the activities were unitary immediately upon acquisition.

The *Appeal of The Signal Companies, Inc.*, Cal. St. Bd. of Equal., January 24, 1990, also involved unity with a newly acquired subsidiary. The taxpayer acquired the subsidiary in May 1975. In June 1975, three of the taxpayer's directors were appointed to the subsidiary's board. By July, the taxpayer's directors formed a majority of the subsidiary's directors and had gained control of the most important committees. In October 1975, an executive from the taxpayer's unitary business was elected as president and CEO of the subsidiary. Over the course of the year, the taxpayer and subsidiary exchanged technical and research information on several projects, the taxpayer-controlled board rejected certain plans that had been made by the former management of the subsidiary and instituted changes, and the subsidiary was included in the central planning being done for the affiliated group.

The taxpayer had included the subsidiary in the combined report from the date of acquisition. Upon audit, the FTB conceded that the subsidiary had become unitary by January 1, 1976, but did not allow combination for 1975. The department argued that the subsidiary was clearly not unity on the date of acquisition, and the taxpayer had failed to establish a clear date during 1975 when unity was achieved. The SBE agreed that the taxpayer was not immediately unitary upon acquisition, and acknowledged that the ties between the companies were gradually established over a period of several months and that there was no single event or specific date upon which unity occurred. On

the other hand, the SBE pointed out that all of the significant integrating factors upon which the FTB based its conclusion that the subsidiary was unitary as of January 1, 1976, were actually in existence by the beginning of the last quarter of 1975. Since the SBE found no basis for distinguishing between the unifying factors existing at January 1, 1976 and October 1, 1975, the SBE concluded that the taxpayer and its newly acquired subsidiary were unitary at least by October 1, 1975.

This case illustrates the importance of determining a date consistent with the unique facts of each case rather than by simply using an arbitrary benchmark.

In *Appeal of Dr Pepper Bottling Company of Southern California, et al.*, Cal. St. Bd. of Equal., December 5, 1990, the taxpayer was a soft drink bottler which was purchased by Dr Pepper Company (DPC), a corporation which manufactured and distributed soft drink concentrates and syrups. The bottler had been a licensee of DPC for many years prior to the acquisition, and over 50% of its concentrate and syrup purchases were from DPC.

The taxpayer/bottler did not file its returns on a combined basis with DPC. Upon audit, the FTB determined that the bottler was instantly unitary with DPC as of the date of acquisition. The taxpayer's argument was that there was no difference in the relationship between the two companies before and after the acquisition other than unity of ownership, and unity of ownership, by itself, cannot compel a finding of unity. The SBE rejected this argument, stating that a "vertically integrated enterprise was pre-existing here, needing only unity of ownership to result in a unitary business." Unity was held to have occurred on the date of acquisition.

To determine the point in time when the integration between two activities has developed to the extent that the unitary tests are met, the auditor must determine the changes that have taken place and the dates upon which those changes occurred. The first step in the analysis should be a detailed description of the operations of the new affiliate prior to the date of acquisition. Any pre-acquisition relationships between the entities should be identified and explained in detail. When examining the details of the acquisition, the auditor should note the exact date on which it occurred, and review the purchase agreement and any other agreements related to the acquisition, which may indicate terms and conditions of the sale. In particular, the auditor should be looking for terms that may limit the acquiring corporation's ability to integrate the new company into its operations. For example, some acquisitions may require that existing officers be retained to continue to operate and manage the target corporation.

Once the background information has been obtained, the next step should be to describe the changes instituted by the parent at the newly acquired corporation, and the exact date that each change took place. Such changes might include:

1. Replacing officers, directors and key managers of the newly acquired subsidiary with individuals from the parent corporation (or from one of its existing subsidiaries);

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2. Providing centralized services such as accounting, legal services, pension plans or computer services to the newly acquired subsidiary;
 3. Transferring funds through intercompany financing;
 4. Imposing the parent company's policies and procedures on the newly acquired subsidiary (e.g., requiring a standard chart of accounts, standardized approval procedures for expenditures, etc.); or
 5. Decisions to discontinue certain product lines, to target new markets, etc.

Suggestions for specific areas to develop and audit techniques to utilize are discussed in MATM 3570 and MATM 3575.

Reviewed: December 2002